No. 11826

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF DANIEL GARTLING, DECEASED, R. N. WEAVER, EXECUTOR, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	2
Statute and Regulations involved	2
Statement	2
Statement of points to be urged	3
Summary of argument	4
Argument:	
I. A partner does not possess an interest in the partnership which, regardless of the nature of the partnership property, is a capital asset whose sale to newly admitted partners results in capital gain	5
II. If relevant, the undisputed facts in this case show that the decedent sold an interest in specific partnership assets and did not sell an interest in the partnership	27
Conclusion	30
Appendix	31

CITATIONS

Cases:	
Burnet v. *Harmel*, 287 U. S. 103	7
City Bank Farmers Trust Co. v. *United States*, 47 F. Supp. 98	25
Commissioner v. *Lamont*, 156 F. 2d 800, certiorari denied, 329 U. S. 782	16
Commissioner v. *Lehman*, 165 F. 2d 383, certiorari denied, May 17, 1948	25
Commissioner v. *Shapiro*, 125 F. 2d 532	26
Commissioner v. *Tower*, 327 U. S. 280	7
Crawford v. *Commissioner*, 39 B. T. A. 521	16
Doyle v. *Commissioner*, 102 F. 2d 86	24
Ellingson v. *Walsh, O'Connor & Barneson*, 15 Cal. 2d 673	19
Helvering v. *Archbald*, 70 F. 2d 720, certiorari denied, 293 U. S. 594	15
Helvering v. *Smith*, 90 F. 2d 590	10, 24
Helvering v. *Walbridge*, 70 F. 2d 683, certiorari denied, 293 U. S. 594	15
Humphrey v. *Commissioner*, 32 B. T. A. 280	26
Jung v. *Bowles*, 152 F. 2d 726	10
Kessler v. *United States*, 124 F. 2d 152	25
Long v. *Commissioner*, decided March 29, 1947	26
Munson v. *Commissioner*, 100 F. 2d 363	26
McClellan v. *Commissioner*, 117 F. 2d 988, affirming 42 B. T. A. 124	26
Neuberger v. *Commissioner*, 311 U. S. 83	15
Reed v. *Industrial Acc. Comm.*, 10 Cal. 2d 191	10
Smith v. *Commissioner*, 10 T. C. No. 49	26

Cases—Continued Page

Stilgenbaur v. *United States*, 115 F. 2d 283 ... 5, 10
Thornley v. *Commissioner*, 147 F. 2d 416 ... 25
United States v. *Flannery*, 106 F. 2d 315 ... 15
Whitney v. *Commissioner*, 8 T. C. 1019 ... 27
Williams v. *McGowan*, 152 F. 2d 570 ... 23

Statutes:

Act of March 3, 1917, c. 156, 39 Stat. 1000, Sec. 201 ... 12
Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Sec. II ... 12
Internal Revenue Code:
Sec. 113 (26 U. S. C. 1940 ed., Sec. 113) ... 31
Sec. 117 (26 U. S. C. 1940 ed., Sec. 117) ... 31
Sec. 181 (26 U. S. C. 1940 ed., Sec. 181) ... 32
Sec. 182 (26 U. S. C. 1940 ed., Sec. 182) ... 32
Sec. 183 (26 U. S. C. 1940 ed., Sec. 183) ... 33
Sec. 184 (26 U. S. C. 1940 ed., Sec. 184) ... 34
Sec. 185 (26 U. S. C. 1940 ed., Sec. 185) ... 34
Sec. 186 (26 U. S. C. 1940 ed., Sec. 186) ... 34
Sec. 187 (26 U. S. C. 1940 ed., Sec. 187) ... 34
Sec. 188 (26 U. S. C. 1940 ed., Sec. 188) ... 35
Sec. 189 (26 U. S. C. 1940 ed., Sec. 189) ... 35
Sec. 3797 (26 U. S. C. 1940 ed., Sec. 3797) ... 35
Reveue Act of 1932, c. 209, 47 Stat. 169, Sec. 1111 ... 11
Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 113 ... 14
Uniform Partnership Act (Civil Code of California (Deering, 1937)):
Sec. 9 ... 10
Sec. 24 ... 17
Sec. 25 ... 10
Sec. 26 ... 18
Sec. 27 ... 18
Sec. 38 ... 11
7 Uniform Laws Annotated (1922), Commissioners' Notes to Secs. 25 and 26 ... 18

Miscellaneous:

G. C. M. 10092, XI–1 Cum. Bull. 114 (1932) ... 14
H. Rep. No. 704, 73d Cong., 2d Sess., p. 18 (1939–1 Cum. Bull. (Part 2) 554) ... 14
H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 42–43 (1939–1 Cum. Bull. (Part 2) 728) ... 16
Lewis, The Uniform Partnership Act, 29 Harv. L. Rev. 158 (1915–1916) ... 9
Lewis, The Uniform Partnership Act, 24 Yale L. J. 617 (1915) ... 9
Rabkin and Johnson, The Partnership under the Federal Taxing Laws, 55 Harv. L. Rev. 909 (1942) ... 11
S. Rep. No. 558, 73d Cong., 2d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 586) ... 15
Sol. Op. 42, 3 Cum. Bull. 61 (1920) ... 14
Treasury Regulations 45, Art. 1570 ... 13
Treasury Regulations 103 ... 36
Sec. 19.113 (a) (13)–1 ... 36
Sec. 19.113 (a) (13)–2 ... 36

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BRIEF FOR THE PETITIONER

OPINION BELOW

The memorandum opinion of the Tax Court (R. 11–13) is not reported.

JURISDICTION

This petition for review (R. 15–16) involves an asserted deficiency of $2,590.87 in individual income tax for the calendar year 1941. The notice of deficiency (R. 7–9) was mailed to the decedent on May 17, 1945. The decedent filed a petition for review with the Tax Court of the United States on July 23, 1945 (R. 4–9), under the provisions of Section 272 of the Internal Revenue Code. Thereafter, the decedent's executor was substituted as a party. (R. 2–3.) The decision of the Tax Court to the effect that there was

a deficiency in income tax for the year 1941 of only \$193.33, and refusing to sustain the Commissioner's deficiency determination in full, was entered on September 8, 1947. (R. 14.) The case is brought to this Court by a petition for review filed by the Commissioner on November 28, 1947 (R. 15–16), pursuant to the provisions of Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

The decedent was a member of a partnership, in which he possessed a one-half interest. He sold a portion of his interest in the partnership assets to two other persons, whereupon the purchasers were admitted to membership in a new partnership in accordance with their interests in the property.

Did the Tax Court err in holding that the decedent sold an "interest in a partnership" which, without regard to the nature of the partnership property, was a capital asset and gave rise to capital gain?

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and regulations involved are set forth in the Appendix, *infra.*

STATEMENT

The facts in this case were stipulated (R. 19–29) and may be summarized as follows:

For many years prior to 1941 the decedent was the owner of a one-half interest in a partnership. The partnership, which was organized in California, was engaged in the manufacture of steel forgings. Its assets consisted chiefly of plant, machinery, inventories, and accounts receivable. (R. 19–20.)

On January 2, 1941, the decedent sold two-thirds of his one-half interest "in and to the property and assets of the said partnership" to Dorothy J. West and William M. Croft. The decedent's tax basis for his interest in the assets sold was $10,679. He received a total of $24,000 on the sale, with a resulting net profit of $13,321. (R. 20.)

Concurrrently with the sale the decedent, his partner, and Dorothy J. West and William M. Croft executed articles of partnership, the new partnership to continue under the same firm name as that used by the preceding firm. (R. 20, 26–29.)

The decedent in his original income tax return for the calendar year 1941 failed to report the sale of any portion of his partnership interest. He later filed an amended return showing a long-term capital gain in the amount of $5,993.83. (R. 20.) The Commissioner, in the deficiency notice, increased the amount of gain to $13,321, and ruled that the entire amount represented ordinary income. Before the Tax Court, the taxpayer conceded that the amount of gain determined by the Commissioner was correct, and that the only question was whether it should be taxed as long-term capital gain or as ordinary income. (R. 21.) The Tax Court ruled that the gain was taxable as gain from the sale of a capital asset held for more than 10 years. (R. 11–13.)

STATEMENT OF POINTS TO BE URGED

The points to be urged by the Commissioner (R. 29–31) are, in substance, that the Tax Court erred in holding that the gain realized by the decedent was

taxable as gain derived from the sale of a capital asset held in excess of 10 years, and in failing to hold that the gain was taxable as ordinary income.

SUMMARY OF ARGUMENT

I

The decedent, who had been a member of a partnership, sold a portion of his interest in the firm's assets, whereupon the firm was reconstituted with the purchasers being admitted as additional partners in accordance with the interest in the property which they had acquired from the decedent. The Tax Court held that the decedent sold "an interest in the partnership" which, without regard to the nature of the partnership property, was a capital asset, and that his gain should be taxed as capital gain. The decision, which is based on the assumption that the partnership, rather than the partners, owns the partnership assets, is contrary to the statutory scheme for taxing partners. Since the partners alone are taxed on the profits of the business, and since they are considered as the owners of the assets of the business, there was nothing which the decedent could sell except his interest in the specific partnership assets. Contrary to the Tax Court's conclusion, the decedent's interest in the profits and surplus of the business, i. e., his interest in the partnership, is not "property" which can be a capital asset. It is either represented by past profits which have been reinvested in physical assets, or by anticipated profits which constitute an intangible asset of the firm. No matter how regarded, the decedent possessed no in-

terest which could be disassociated from the assets of the firm. The character of the gain which he realized when he made a sale to the newly admitted partners can only be determined from the nature of the assets sold. Since there was no proof in this case that he sold any capital assets, the Commissioner's determination that his gain was ordinary income should have been sustained by the Tax Court.

II

The holding of this Court in *Stilgenbaur* v. *United States,* 115 F. 2d 283, is in accord with the Commissioner's principal position. However, the Court there employed some language which would indicate that a partner could sell either his interest in the partnership assets, or his interest in the firm. While we do not believe that this distinction is sound, it will, if accepted, equally require a reversal in this case since the undisputed facts here are that the decedent sold an interest in the partnership assets and not an interest in the partnership. Since it has not been established that the gain was derived from capital assets, the Tax Court was wrong in holding that the gain is to be taxed as capital gain.

ARGUMENT

I

A partner does not possess an interest in the partnership which, regardless of the nature of the partnership property, is a capital asset whose sale to newly admitted partners results in capital gain

The decedent for many years was the owner of a one-half interest in a California partnership. On

January 2, 1941, he sold a one-sixth "interest in and to the property and assets" of the partnership to Dorothy J. West, and a similar interest to William M. Croft, thus retaining a one-sixth interest in such assets for himself. (R. 19–20, 24, 25.) Concurrently, a new partnership agreement was drawn up to govern the new partnership, with Dorothy J. West and William M. Croft admitted as partners, and with the decedent (having a one-sixth interest) and his former partner (having a one-half interest) continuing as partners. (R. 26–29.) The decedent received $12,000 for his interest in the assets conveyed to each of the new partners, or a total of $24,000. His basis for his interest in those assets was $10,679, and his undisputed gain on the sale was $13,321. (R. 20.) The only issue in the case is whether this gain is to be taxed as gain on the sale of a capital asset because, as the Tax Court held, the decedent sold a "partnership interest," which the Tax Court considers to be a capital asset (R. 11–13), or whether, as the Commissioner contends, because the decedent sold a fractional portion of his interest in the partnership assets, the resulting gain is taxable as ordinary gain except to the extent that the taxpayer is able to show that the gain is attributable to the sale of assets which come within the statutory definition of capital assets.

The decision of the Tax Court to the effect that a partner possesses an interest in the partnership which, by itself, and without regard to the nature of the partnership assets, is a capital asset which can be sold, and whose sale may give rise to a capital

gain or a capital loss, is contrary to the congressional scheme for taxing partners and has given rise to a fundamental misapplication of the statute in this case.

At the outset, it will be noted that the Tax Court (R. 12–13) starts with the assumption that local law respecting partnerships is the ultimate source which controls the determination of what the decedent sold to the incoming partners. While, as will be seen, the Tax Court was altogether mistaken about the California law of partnerships, it is considered important to point out that the federal law relating to the taxation of partners is one to be given a uniform, nationwide application, and that Congress never intended that the incidents of such taxation should vary from state to state, depending upon the peculiarities of local law. See *Burnet* v. *Harmel,* 287 U. S. 103. Cf. *Commissioner* v. *Tower,* 327 U. S. 280, 287–288. There is nothing in the statutory pattern which would admit the conclusion that Congress intended that the varying rules of local law respecting partnerships should be the initial and ultimate reference point from which the federal taxing problems are to be orientated.[1]

[1] It will be noted that the Tax Court stated (R. 12) that the Commissioner "concedes the law of California is controlling." While the Commisssioner's brief below stated that the law of California governed the present case, it is clear from the brief as a whole that this only meant that the law of California, where the Uniform Partnership Act prevails, reflects the same basic theory which underlies the federal statutory pattern for taxing partners, namely, that the partners are the owners of the firm assets and that the firm is not an intervening entity which is the owner of those assets.

Having started with the erroneous view that local law is altogether controlling, the Tax Court compounded its error by assuming that in States where the Uniform Partnership Act has been adopted the partnership, as an entity, owns the partnership assets, and that the individual partners do not. From these invalid premises, the Tax Court arrived at the erroneous conclusion that the sale by a partner to incoming partners of a portion of his interest in the firm assets is not a sale of those assets, but is the sale of something altogether different. We propose to demonstrate why these premises and this conclusion are wrong.

The Uniform Partnership Act may be selected as a general guide for the analysis of the nature of a partner's interest, not because that Act controls the interpretation to be given to the taxing statute (as the Tax Court erroneously assumed), but because it basically codified the theory which was then dominant in the jurisprudence of the several States, a theory which Congress had already adopted in the taxation of partnership gains to the partners. Contrary to the Tax Court's views on this, the Uniform Partnership Act does not express the theory that the partnership is an entity separate and apart from the partners, and that it is the legal owner of the partnership assets; on the contrary, the Uniform Act was drafted on the so-called "aggregate" theory, namely, that the partners, holding by a peculiar type of tenancy described in the Act, are the only legal owners of the partnership property. Indeed, whether the "entity" or the "aggregate" theory of partnerships should have

been adopted was one of the focal points of controversy that attended the drafting of the Uniform Act. At this late date there can be no doubt the the theory described by the Tax Court was the very one rejected, after full consideration, by the conference of Commissioners on Uniform State Laws. See Lewis, The Uniform Partnership Act, 24 Yale L. J. 617, 640 (1915), where, after outlining the history of the drafting of the Uniform Partnership Act, the author, who was also the final draftsman, states:

> At the conclusion of the discussion, the members of the conference all joined in recommending that the Act be drawn on the common law or aggregate theory, and that the partners be treated as owners of partnership property holding by a special tenancy, which should be called tenancy in partnership. This recommendation, as explained, has been carried out.

See further, Lewis, The Uniform Partnership Act, 29 Harv. L. Rev. 158–192, 291–313 (1915–1916), where it is stated by way of summary (p. 296):

> * * * the adoption of the Act makes it impossible for a court to hold a partnership a legal person, in view of the definition in Section 6, and the express statement in Section 25, that the partners, and therefore assuredly not a fictitious legal person, are co-owners of partnership property holding as tenants in partnership. The theory on which the Act is drawn may be wrong, but a reading of its provisions will show that the Commissioners have adhered to the aggregate theory, dominant in our partnership cases, and have not adopted the legal-person theory.

Accord: *Helvering* v. *Smith,* 90 F. 2d 590, 590–591 (C. C. A. 2d). California follows this theory in the interpretation of the provisions of the Uniform Act which has been enacted in that State. *Reed* v. *Industrial Acc. Comm.,* 10 Cal. 2d 191; *Stilgenbaur* v. *United States,* 115 F. 2d 283 (C. C. A. 9th); *Jung* v. *Bowles,* 152 F. 2d 726 (C. C. A. 9th).

A brief review of the provisions of the Uniform Act will demonstrate how it carries through this theory. Section 25 (1) óf the Uniform Act (Section 2419 (1), Civil Code of California (Deering, 1937)) states—

> A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

The incidents of this tenancy in partnership are such that each partner has the right to possess the property for partnership purposes, to have no assignment by the other partners except as all assign their rights, to have the property seized only by partnership creditors, and to continue to possess the property for partnership purposes on the death of any other partner. Section 25 (2) of the Uniform Act (Section 2419 (2), Deering, *supra*). Each partner has the power, as an agent of the other partners, to convey such assets for partnership purposes. Section 9 of the Uniform Act (Section 2403, Deering, *supra*). Each partner also has the right, on dissolution, to have the specific partnership property dedicated to partnership debts and the surplus applied to paying the amounts owing to the respective partners. Sec-

tion 38 of the Uniform Act (Section 2432, Deering, *supra*).

While the incidents of this tenancy in partnership differ from those that attended the more ancient forms of common ownership developed by the common law, it is clear that under the Uniform Act the partners, and they alone, are the owners of the partnership property.

The aggregate theory of partnerships which was dominant in the common law before the drafting of the Uniform Act, and which was reflected in the basic provisions of the Uniform Act, expresses the hypothesis on which Congress has generally acted with respect to the taxation of the members of a partnership. See Rabkin and Johnson, The Partnership under the Federal Taxing Laws, 55 Harv. L. Rev. 909 (1942).

The starting point for ascertaining the federal taxing pattern is Section 3797 (a) (2) of the Internal Revenue Code (Appendix, *infra*) which contains the following definition: [2]

> The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

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[2] The same definition has existed ever since the adoption of Section 1111 (a) (3) of the Revenue Act of 1932, c. 209, 47 Stat. 169.

Thus, it is readily apparent that the taxing statute is not concerned with anything peculiar to partnerships under local law, but treat alike other kinds of business organizations which possess a unifying thread, namely, common ownership of the business assets by the persons who comprise the organization. This theme runs throughout the provision of the Code relating to the taxation of the partnership gains to the partners. The partnership, as thus defined, is not a taxable entity as a corporation is; instead, only the individual partners are liable to be taxed in their individual capacities for the partnership earnings. Section 181 of the Internal Revenue Code (Appendix, *infra*).[3] The partners, moreover, are taxable on their distributive shares of the partnership income, regardless of whether the profits are actually distributed. Section 182 of the Internal Revenue Code (Appendix, *infra*).[4] The taxing statute has thus not only treated the partners as having realized gain on a disposition of partnership assets exactly as would be true if they were the common owners of those assets, but it has also completely disregraded the fact that under the partnership agreement, or under local law, the partners might not be able to reap the profits at that time. Undistributed profits, to the extent reinvested, merely represent additional property acquired by the part-

[3] This has, with one exception, been true ever since Section II D of the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166. The tax on excess profits imposed by the Act of March 3, 1917, c. 156, 39 Stat. 1000, was imposed on partnerships as well as on corporations by Section 201 of that Act.

[4] With the exception noted in the preceding footnote, this has also been true ever since the adoption of the 1913 Act.

ners and a possible source of future profits. Further, the character of the partnership income (whether capital gain or ordinary income) retains its identity and is taxable to the partners in the same manner as though they had individually sold assets possessing a common ownership. Sections 182 and 183 (a) and (b), Internal Revenue Code (Appendix, *infra*). Again, charitable contributions made by the partnership are allowable as deductions to the individual partners only to the extent that their distributive shares of the donations would be allowable to them as individuals. Section 183 (c), Internal Revenue Code (Appendix, *infra*). Also, the benefit of a deduction for the partnership's net operating losses in the form of a carry-back or carry-over is not allowed to the partnership, but only to the individual partners. Section 189, Internal Revenue Code (Appendix, *infra*).

Further evidence that the taxing statute regards the ownership of partnership assets as being only that of the partners is to be found in the fact that no gain or loss is realized when appreciated or depreciated property is contributed in kind by a partner to the firm, or when such property is distributed in kind by the firm to the partners. Ever since Article 1570, Treasury Regulations 45, promulgated under the Revenue Act of 1918, the Treasury Regulations have explicitly stated that when the partnership dissolves and the firm assets are distributed in kind, no gain or loss is realized by the partners until they dispose of the assets. See Section 19.113 (a) (13)-1, Treasury Regulations 103 (Appendix, *infra*). It has also

been the rule that no gain or loss is realized by a partner when he contributes assets to the partnership which have appreciated or depricated in value in his hands. See Sol. Op. 42, 3 Cum. Bull. 61 (1920), interpreting the Revenue Act of 1916; G. C. M. 10092, XI-1 Cum. Bull. 114 (1932). These views were specifically enacted in statutory form by the adoption of Section 113 (a) (13) of the Revenue Act of 1934, c. 277, 48 Stat. 680, which bears the same section number in the Internal Revenue Code (Appendix, *infra*). It is important to note that, in adopting this provision of the 1934 Act, Congress merely viewed it as declaratory of existing law.[5]

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[5] H. Rep. No. 704, 73d Cong., 2d Sess., P. 18 (1939-1 Cum. Bull. (Part 2), 554, 567-568). The House Committee on Ways and Means, with reference to this provision, stated:

"The committee also proposes two important changes in connection with the basis provisions, for the purpose of making it entirely certain that there can be no use of the partnership as a medium of tax avoidance in cases of sales of property which has appreciated in value. The result of the provisions of section 113 (a) 13 is that if property is purchased by a partnership the basis of such property to the partnership shall be its cost; but if the property is paid in by a partner then the basis to the partnership shall be the cost or other basis to the partner. The committee believes that this provision simply makes specific the correct interpretation of the general provisions of the present law. Paragraph (13) further provides that if property is distributed in kind by a partnership to a partner, the basis to the partner shall be a proper proportionate part of the cost or other basis to him of his interest in the partnership. An example will make the operation of this proposal clear. Suppose that a partner, A, paid $10,000 for his interest in a partnership. Suppose that the partnership distributes to the partners property in kind representing one-half of its assets. Irrespective of the value of this property at the time of its distribution, the basis to A of the property distributed to him will be $5,000, and he will be taxed on any amount for which he thereafter disposes of

In certain limited respects the statute employs the partnership as a unity for accounting purposes. Thus, the partnership, in filing its informational return under Section 187 of the Internal Revenue Code (Appendix, *infra*), may compute the partnership income on a different fiscal basis than that employed by the individual partners in reporting their own income. See Section 188 of the Internal Revenue Code (Appendix, *infra*). Also, the partnership may compute its income by use of either the cash or the accrual method of accounting, without regard to the method of accounting employed by the individual partners. See Rabkin and Johnson, *supra,* p. 912. However, except as Congress has specifically recognized the business association as a unit, it has uniformly taxed the partners as being the common owners of the business assets. See *Neuberger* v. *Commissioner,* 311 U. S. 83. When Congress has seen fit to make such a departure, it was recognized that this was a deviation from the aggregate theory which has always shaped the basic statutory pattern. Thus, during the period of 1933 to 1937 Congress

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the property in excess of $5,000. The committee believes that this provision embodies merely the correct interpretation of the present law but it appears desirable to have an express statement of the rule in the statute."

See also S. Rep. No. 558, 73d Cong., 2d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 586, 600–601). To the extent that a contrary rule was reached for taxable years prior to the adoption of the amendment, in *Helvering* v. *Archibald*, 70 F. 2d 720 (C. C. A. 2d), certiorari denied, 293 U. S. 594; *Helvering* v. *Walbridge*, 70 F. 2d 683 (C. C. A. 2d), certiorari denied, 293 U. S. 594; and *United States* v. *Flannery*, 106 F. 2d 315 (C. C. A. 4th), it is clear that those decisions were contrary to Congress' concept of the statute.

prevented the partners from deducting against individual capital gains the partnership capital losses which were in excess of partnership capital gains by more than $2,000. *Commissioner* v. *Lamont,* 156 F. 2d 800 (C. C. A. 2d), certiorari denied, 329 U. S. 782. See *Neuberger* v. *Commissioner, supra,* for the contrary rule which had prevailed before 1933. This was deemed to be an exception to the general statutory pattern for when Congress, in the 1938 Act, again permitted the partners to offset against individual capital gains their distributive shares of the partnership long term capital losses, it was recognized that the rule during the preceding period had been a departure from the prevailing statutory scheme. See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 42–43 (1939–1 Cum. Bull. (Part 2) 728, 758–759).

We submit, accordingly, that there is no foundation for the Tax Court's conclusion that Congress has treated a partnership, like a corporation, as being the owner of the business assets.[6] On the contrary, we believe it manifest that the taxing statute generally regards the partners, and they alone, as the owners of the firm assets, and that the taxation of

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[6] The views of the Tax Court in the present case concerning the ownership of partnership property may be contrasted with those set forth in *Crawford* v. *Commissioner*, 39 B. T. A. 521, where, in holding that there is no gain or loss on a proportionate distribution of partnership assets in kind to the partners, it was said (p. 524):

"An ordinary partnership, such as we have here, has no entity in the sense that it may own property separate and apart from the ownership thereof of its members. The members, at all times, own the partnership business and the assets employed in it, and are, therefore, never separated from title thereto."

gain on the sale of those assets has always been considered as being the gain, proportionately, of the partners who own those assets.

When the basic matter of the proper ownership of partnership assets under the taxing statute has been correctly settled, the precise issue of this case is brought into focus more sharply. The question that must be answered is: Does a partner, in addition to his ownership rights with respect to the partnership assets, possess a "property" right in relationship to the firm which, by itself, can constitute an incidence of gain or loss and which is the kind of "property" which Section 117 (a) (1) of the Internal Revenue Code (Appendix, *infra*) defines as a "capital asset"? It is the Commissioner's position that this question must be answered in the negative.

If a partner does possess something (in addition to his ownership of partnership property) which the taxing statute regards as "property" which is capable of being a capital asset, it becomes pertinent to inquire what the nature of this may be. We may again refer to the Uniform Act, not because it controls the tax question but because it demonstrates the source of the Tax Court's ultimate error. Section 24 of the Uniform Act (Section 2418, Deering, *supra*) provides:

> The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management.

Section 26 of the Uniform Act (Section 2420, Deering *supra*) further defines the partner's "interest in the partnership" as being "his share of the profits and surplus" and states that this is to be personal property. Totally oblivious of the partner's rights in specific partnership property, the Tax Court seizes on the partner's interest in the "profits and surplus" of the firm and declares this to be the "property" which constitutes a capital asset under Section 117 (a) (1) of the Internal Revenue Code.

In the context of the Uniform Act, a partner's interest in the partnership (i. e., in the firm's profits and surplus) performs a very important function for it permits a partner to assign his interest in the firm without the assent of his partners, thus entitling his assignee to receive the assignor's share of future profits; the assignment, however, does not dissolve the partnership, it does not make the assignee a partner, and it does not make him a co-owner with the other partners of the specific partnership assets. Section 27 of the Uniform Act (Section 2421, Deering, *supra*). The purpose of this section was to clarify what had been a source of great confusion in the state of the law as it had developed prior to the codification. See: Commissioners' Notes to Sections 25 and 26, 7 Uniform Laws Annotated (1922); Lewis, *supra*, 24 Yale L. J. 617, 626.

Although, as we shall show, a partner's interest in the firm does not possess an equal significance in the taxing statute and cannot itself be a source of gain or loss, we believe it significant that the present case is not at all one of an assignment of a partner's "in-

terest in the partnership" which would merely have entitled the assignees to receive the assignor's share of the profits. Here, rather, with the assent of the decedent's partner, there was a dissolution of the old partnership and the formation of a new firm with the decedent's transferees admitted as partners. *Ellingson* v. *Walsh, O'Connor & Barneson,* 15 Cal. 2d 673, 676. The incoming partners in this case are entitled to share in the firm's future profits, not because the decedent transferred his interest in the firm without his co-partner's consent, but rather because he sold his interest in the specific partnership assets, as he was entitled to do with his partner's assent, and because his transferees, with the consent of all, contributed that interest to the formation of the new firm. They share the new firm's profits because they are partners, and not as assignees of an interest in the old firm. Since the only thing that the decedent could have sold in the context of the present case, as would be true of any similar situation, was his interest in the specific assets of the firm as they existed at the time of dissolution, those assets were the only source of his admitted gain. If local law be emphasized, those assets are the only factors which can determine the nature of the gain, namely, whether it be ordinary gain or capital gain under Section 117 (a) (1) of the Internal Revenue Code.

Returning to a consideration of the tax statute, it will be seen why, without regard to the mechanics of local partnership law, an interest in the firm's profits and surplus cannot be the source of gain and cannot be the "property" referred to in Section 117

(a) (1). Bearing in mind that a partner, as long as he remains a partner, is taxed on his annual share of the partnership profits without regard to whether those profits are withdrawn from the business, it is self-evident that a partner's interest in past profits, as such, cannot be the subject matter on which further taxable gain or loss can be sustained. That is so whether the sale be to the remaining partners, to incoming partners, or to third persons. To the extent that profits previously earned and taxed have been withdrawn from the business, there can clearly be no further loss or gain on those profits. To the extent that past profits have been permitted to remain in the business, they will be represented either by cash or by other physical assets which have been purchased with those profits. It seems self-evident that a transfer of past-profits at a taxable gain or loss would be meaningless—the only thing that could be sold at a taxable gain or loss would be the property in which those profits have been invested.

Accordingly, when a partner sells a portion of his so-called interest in a partnership at a profit, what is sold must be related to the then existing partnership property. Where, as here, there is a taxable gain on the sale, it is explicable for one or a combination of several reasons. (1) Partnership property may have appreciated in value after the time when it was acquired by the firm. Where this is the case, the incoming partner will normally pay for his proportionate share of the then existing value of the firm assets. He will not be concerned with and his payment will obviously have no relationship

to the tax basis of the selling partner. In such an event, the selling partner's disposition of a portion of his interest in the firm's appreciated assests for cash should be the occasion for taxing gain since he has realized some part or all of the appreciation at that time. (2) There may have been no appreciation in value while the assets were held by the firm, but there may have been a prior appreciation in value in the partner's hands, but which was not realized earlier because contributed by the partner to the firm. See Section 113 (a) (13), Internal Revenue Code. In such a situation, too, the value of the assets at the time that the incoming partner purchases his interest may be determinative of what is paid, and it will have no relationship to the selling partner's tax basis. Again, since the selling partner has realized the increment in value which was not previously taxed, the gain becomes taxable at the time of the sale. (3) The tax basis of the property may differ from its physical value at the time of the sale because prior allowable or allowed deductions for depreciation have been greater than the actual physical depreciation. In this case, as frequently occurs with respect to any business property, the previous reductions in tax basis afforded because of the prior deductions for depreciation require that the gain be taxed when the sale is made. In all these instances, the character of the gain must relate to the type of property which has been the source of the profit. If it was a capital asset, the gain should be taxed as capital gain; if it was a non-capital asset, the gain should be taxed as ordinary income.

The question arises whether a partner may not sell his interest in the future profit making ability of the firm, and whether, when an incoming partner is willing to pay more than is represented by his proportionate share of the physical assets, there is not a sale of an interest in such future profits which, not being directly associated with the existing physical assets of the firm, can constitute a property right which, itself, ~~it~~ is capable of being a capital asset. In a proper situation where future profit making ability of a business enterprise is capable of being evaluated, it would constitute an intangible asset of the partnership, expressed in terms of "good-will." Where the selling partner disposes of all or a portion of his interest in the good-will of the firm, this would constitute a sale of one of the partnership assets just as would be true of the sale of any of the physical assets. Where this is the source of gain to the selling partner, it may constitute the sale of a capital asset and a resulting capital gain. The total gain derived by the selling partner, however, may be only partly attributable to good-will, with the rest derived from the sale of other partnership assets. It is certainly erroneous, in any situation, to lump the whole gain together and classify it as capital gain. The only correct procedure is to examine the source of the gain and to determine its nature from the type of asset sold.

It should be emphasized that the present case does not involve the sale of any good-will. None appeared on the partnership books, and the taxpayer has never claimed or proved that future profit making ability

of the partnership accounted for any portion of the gain which was realized by the decedent.

Because a partner, unlike a stockholder, is treated by the taxing statute as a co-owner of the business assets who is taxable on the partnership profits, and because the partnership, unlike a corporation, is not a taxable business entity, it must be concluded that Congress never envisaged a partner as possessing a right in the business which can be disassociated from the business assets and which, by itself, can be considered "property" that can fulfill the definition of a capital asset. Instead, a person who is associated with others in conducting a partnership business differs from an individual who conducts a business as a sole proprietorship only in the respect that the former is a co-owner, holding by a tenancy in partnership, of the business assets, while the latter is the sole owner. Where an individual proprietor sells his business as a going concern, or an interest in it, each asset sold must be examined to determine its nature. *Williams* v. *McGowan,* 152 F. 2d 570 (C. C. A. 2d). Similarly, where a partner sells all or part of his interest in the firm assets, the character of any gain can only be ascertained by an examination of the items of property which have been sold.

Where items of partnership property are sold in the ordinary course of the partnership business, it is clear that the partners are to be taxed in accordance with the nature of the items of property sold. Sections 182 and 183, Internal Revenue Code (Appendix, *infra*). When an interest in those assets is trans-

ferred to an incoming partner, there is nothing in the statute to indicate that Congress intended a different result, or that it ever envisaged that items of property which would give rise to ordinary income when sold in the oridinary course of business, become transformed in character upon a sale to an incoming partner, and that the sale of ordinary assets in those circumstances should emerge as capital gain. See *Helvering* v. *Smith,* 90 F. 2d 590 (C. C. A. 2d), holding that a lump sum payment by the continuing partner to a retiring partner is taxable as ordinary income to the recipient, there being no capital assets in the firm which could have been the subject matter of a sale, and *Doyle* v. *Commissioner,* 102 F. 2d 86 (C. C. A. 4th), where it was held that a retiring partner who received a stipulated amount from his former partner on account of a disputed legal fee which had not yet been collected, was taxable as having received ordinary income.

A further, and conclusive reason which demonstrates the invalidity of the Tax Court's conclusion lies in the fact that it creates differences where none were ever intended by Congress. Considering a partner's interest in the partnership earnings and surplus as capable of being sold as a capital asset, the Tax Court reaches a result which is *sui generis* with respect to partnerships. Yet, as we have seen, Congress, by Section 3797 (a) (2) of the Internal Revenue Code, has plainly legislated on the supposition that all of the business organizations there defined as partnerships are to be taxed exactly the same, and that a business organization which qualifies

as a partnership under local law is to be considered no different than the other organizations there defined. In the other types of organizations where the members are taxed as partners, it would seem undeniable that upon the admission of a new member the selling member would having nothing to sell except his common interest in the business assets, and that his interest in the business could not, of itself, constitute a capital asset. We submit that Congress did not intend that a member of an organization which happens to qualify as a partnership under local law should be given different tax results than those which would obtain in the case of the members of any other organization which Congress has also defined as a partnership.

The decisions on this point are in an unsatisfactory state. In *City Bank Farmers Trust Co.* v. *United States*, 47 F. Supp. 98, where there was a sale of a partner's interest and the partnership property was composed of capital assets, the Court of Claims held that the holding period for determining the taxable amount of capital gain must be related to the time that each specific partnership asset had been held. This view is in accord with the basic principles expressed herein, as are the decisions in *Helvering* v. *Smith, supra,* and *Doyle* v. *Commissioner, supra.* It is opposed, however, by *Thornley* v. *Commissioner,* 147 F. 2d 416 (C. C. A. 3d),[7] and *Commissioner* v. *Lehman,* 165 F. 2d 383 (C. C. A. 2d), certiorari denied, May 17, 1948, both of which decided that the

[7] See also *Kessler* v. *United States*, 124 F. 2d 152 (C. C. A. 3d).

holding period relates to the time that the selling partner was a partner. In *Commissioner* v. *Shapiro,* 125 F. 2d 532 (C. C. A. 6th), it was held that gain realized by a partner on retirement was taxable as capital gain. It appears from the opinion in that case that some of the assets owned by the partnership were non-capital in nature, but there is nothing to indicate whether the gain represented previously unrealized appreciation of such assets. On the other hand, the partnership possessed good-will and, perhaps, other intangibles which would have been capital assets and a possible source of the capital gain.[8] Rabkin and Johnson, *supra,* say of this case (fn. 40, p. 927):

> The holding may be reconciled with the other cases on the hypothesis that "going value" or "good will" is itself a capital asset.

In *McClellan* v. *Commissioner,* 117 F. 2d 988 (C. C. A. 2d), affirming 42 B. T. A. 124, and *Munson* v. *Commissioner,* 100 F. 2d 363 (C. C. A. 2d), the holding that the retiring partner had sold a capital asset can be explained on the ground that the partnership assets (stock exchange seats) which occasioned the loss in the *McClellan* case and the gain in the *Munson* case were, themselves, capital assets. The position of the Tax Court in this and similar cases,[9] which is

[8] The bill of sale in the *Shapiro* case, p. 534, included "good-will, copyrights, formulae, trade name, book accounts, mailing lists, machinery and equipment."

[9] *Long* v. *Commissioner* decided March 29, 1947 (1947 P. H. T. C. Memorandum Decisions Service, par. 47, 155), pending on cross petitions for review in the Circuit Court of Appeals for the Fifth Circuit; *Smith* v. *Commissioner,* 10 T. C. No. 49; and *Humphrey* v.

founded on the notion that the partnership, and not the partners, owns the firm assets, may be contrasted with the opposing view which it expressed in *Crawford* v. *Commissioner, supra.* This Court's decision in *Stilgenbaur* v. *United States, supra,* which takes an intermediate position on the matter, will be discussed under Point II, *infra.*

II

If relevant, the undisputed facts in this case show that the decedent sold an interest in specific partnership assets and did not sell an interest in the partnership

We believe that the analysis under Point I, *supra,* is sound and embodies the correct solution to the type of problem which is raised by this kind of case. Accordingly, we submit that it was error for the Tax Court to hold that the decedent had sold a capital asset. Absent any proof that the gain was attributable to capital assets sold to the incoming partners, the Tax Court should have sustained the Commissioner's deficiency determination which found that no capital gain had been realized.

In *Stilgenbaur* v. *United States, supra,* this Court held that the retiring partner there had sold to the continuing partners his interest in the specific partnership property; it was held that the loss was a capital loss because those assets were capital assets. The decision in the *Stilgenbaur* case is fully in accord with the result which the Commissioner contends

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Commissioner, 32 B. T. A. 280 (nonacquiescence XIV–2, Cum. Bull. 34 (1935)). See also *Whitney* v. *Commissioner*, 8 T. C. 1019, pending on cross petitions for review in the Circuit Court of Appeals for the Second Circuit.

should apply in this case, namely, that the gain is taxable as capital gain only to the extent that the assets sold are capital assets, and that it is ordinary income to the extent that they are noncapital assets.

There is, however, some *dicta* in the *Stilgenbaur* case which would seem to envisage a partner as selling his "partnership interest" where he so intends. That is, the decision holds that where a selling partner states that he is selling his interest in the firm's assets, the nature of the gain is controlled by the nature of those assets. However, the decision intimates that if he declares that he is selling his "partnership interest," this might be the sale of a capital asset, although it is not clear whether this was intended to imply that such a sale would always be that of a capital asset. If that was the intent of the *dicta,* we submit, in the light of the analysis under Point I, *supra,* that the indicated result would be erroneous. We firmly believe that the tax consequences ought not depend upon the words employed; since the effect of the transfer, whether denominated as a sale of a partnership interest or as a sale of an interest in partnership assets, is precisely the same, the application of the taxing statute ought to be the same, uninfluenced by the choice of language in the instrument of transfer. If the transferor sells an interest in non-capital assets to the incoming partners, he ought not to receive the benefit of the tax on capital gains merely because the bill of sale refers to a "partnership interest" as having been sold and does not speak in terms of the interest in the partnership assets which is actually being conveyed.

If this Court, however, should decide to adopt the *dicta* of the *Stilgenbaur* case, and should hold that the issue turns on the nature of the language employed, it should be observed the Tax Court's decision on the facts of this case would be contrary to this position. The undisputed facts in this case show that the bills of sale each recited that the decedent had sold (R. 24, 25) "an undivided one-sixth (1/6), interest in and to the property and assets" of the partnership. The new articles of the partnership agreement also recited that the decedent had sold to the incoming partners (R. 26) "two-sixths' of said mentioned undivided interest in and to the property and assets of said partnership." Also, the stipulation refers only to a sale of a portion of the decedent's interest (R. 20) "in and to the property and assets of the said partnership." Nowhere is there any mention of a sale of a "partnership interest." Accordingly, if under the *Stilgenbaur* case a distinction is to be drawn between the sale of a partnership interest and the sale of an interest in partnership assets, it is clear that the decedent here sold an interest in partnership assets and not in the partnership. The decision of the Tax Court, in holding to the contrary, is contrary to the evidence.[10] Since it was stipulated (R. 19–20) that the assets of the partner-

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[10] The Tax Court's decision contravenes the evidence in another respect. The stipulation (R. 20) only establishes the decedent's tax basis for the interest in the partnership assets which he sold. There is no evidence of his basis for the so-called "partnership interest", if any exists and was sold. The Tax Court, unsupported by any evidence, assumed (R. 12) that the basis for the "partnership interest" was the same as the basis for the partnership assets.

ship "consisted chiefly of the plant, machinery, inventories and accounts receivable", and since these items would be excluded from the definition of a capital asset under Section 117 (a) (1), because constituting stock in trade, or property properly included in inventory, or property subject to depreciation, the Tax Court was wrong in deciding that the gain was capital gain. At all events, if the gain was derived from capital assets, it was for the taxpayer to prove this. Since no such proof was made, the Commissioner's determination that the gain was ordinary income should have been sustained by the Tax Court.

CONCLUSION

In view of the foregoing, the decision of the Tax Court should be reversed.

Respectfully submitted.

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JUNE 1948.

APPENDIX

Internal Revenue Code:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(13) *Partnerships.*—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any other paragraph of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

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(26 U. S. C. 1940 ed., Sec. 113.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1);

(2) *Short-term capital gain.*—The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income:

* * * * *

(b) *Precentage taken into account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

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(26 U. S. C. 1940 ed., Sec. 117.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(*a*) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(*b*) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(*c*) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (*b*). (26 U. S. C. 1940 ed., Sec. 182.)

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(*a*) *General rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (*b*) and (*c*).

(*b*) *Segregation of items.*—

(1) *Capital gains and losses.*—There shall be segregated the short-term capital gains and losses and the long-term capital gains and losses, and the net short-term capital gain or loss and the net long-term capital gain or loss shall be computed.

(2) *Ordinary net income or loss.*—After excluding all items of either short-term or long-term capital gain or loss, there shall be computed—

(A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or

(B) An ordinary net loss which shall consist of the excess of the deductions over the gross income.

(*c*) *Charitable contributions.*—In computing the net income of the partnership the so-called "charitable contribution" deduction allowed by section 23 (o) shall not be allowed; but each partner shall be considered as having made payment, within his taxable year, of his dis-

tributive portion of any contribution or gift, payment of which was made by the partnership within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted. (26 U. S. C. 1940 ed., Sec. 183.)

Sec. 184. Credits against net income.

The partner shall, for the purpose of the normal tax, be allowed as a credit against his net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25 (a) as are received by the partnership. (26 U. S. C. 1940 ed., Sec. 184.)

Sec. 185. Earned income.

In the case of the members of a partnership the proper part of each share of the net income which consists of earned income shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary and shall be separately shown in the return of the partnership. (26 U. S. C. 1940 ed., Sec. 185.)

Sec. 186. Taxes of foreign countries and possessions of United States.

The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in Section 131. (26 U. S. C. 1940 ed., Sec. 186.)

Sec. 187. Partnership returns.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations

prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners. (26 U. S. C. 1940 ed., Sec. 187.)

SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner. (26 U. S. C. 1940 ed., Sec. 188.)

SEC. 189 (as added by Section 211 (d) of the Revenue Act of 1939, c. 247, 53 Stat. 862) NET OPERATING LOSSES.

The benefit of the deduction for net operating losses allowed by section 23 (s) shall not be allowed to a partnership but shall be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary. (26 U. S. C. 1940 ed., Sec. 189.)

SEC. 3797. DEFINITIONS.

(*a*) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

*   *   *   *   *

(2) *Partnership and partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in

such a syndicate, group, pool, joint venture, or organization.

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(26 U. S. C. 1940 ed., Sec. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.113 (a) (13)–1. *Property contributed in kind by a partner to a partnership.*—The basis of property contributed in kind by a partner to partnership capital after February 28, 1913, is the cost or other basis thereof to the contributing partner. Annual allowances to the partnership for depletion and depreciation are to be computed on such basis. If such basis is greater than the fair market value of the property at the date of the transfer to the partnership, the annual depletion or depreciation allowances shall be allocated to and included in the determination of the distributive shares of the partners in accordance with their agreement in respect of the sharing of gains or losses affecting partnership capital. If the basis of such contributed property is less than the fair market value thereof at the date of transfer to the partnership, the annual allowances for depletion and depreciation are to be limited to such basis and may be apportioned among the partners according to their agreement with respect to the sharing of gains or losses affecting partnership capital. On the sale or other disposition of such contributed property by the partnership the gain or loss, determined on such transferred basis, adjusted as required by section 113 (b), shall be prorated in determining the distributive shares of the partners according to their gain or loss ratios on the disposition of a partnership asset under the partnership agreement.

Sec. 19.113 (a) (13)–2. *Readjustment of partnership interests.*—When a partner retires from a partnership, or the partnership is dis-

solved, the partner realizes a gain or loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. However, if such interest in the partnership was acquired prior to March 1, 1913, both the cost or other basis as hereinbefore provided and the value of such interest as of such date, plus the amount of his share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid, shall be ascertained, and the gain derived or the loss sustained shall be computed as provided in section 19.111–1. See also section 117. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. The basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

If a new partner is admitted to the partnership, or an existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain has been realized or loss sustained by any partner.

U. S. GOVERNMENT PRINTING OFFICE: 1948